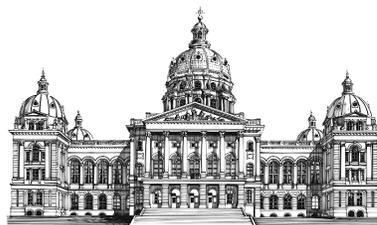


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State Capitol
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Iowa's Tobacco Settlement

ISSUE

This *Issue Review* provides an overview of Iowa's tobacco settlement, the securitization process, and the potential for cash flow problems during FY 2002.

AFFECTED AGENCIES

Treasurer of State, Office of the Attorney General, Department of Management, Department of Human Services, Department of Public Health, Department of Corrections, Department of Education, Department of General Services.

CODE AUTHORITY

Chapter 12, Code of Iowa
Chapter 12E, Code of Iowa

BACKGROUND

On November 20, 1998, 46 states approved a settlement agreement with the four major tobacco industry manufacturers that comprised 99.4% of the U.S. cigarette market. The manufacturers agreed to a settlement valued at \$206.4 billion to be paid over 25 years to settle tobacco-related lawsuits filed by the states. This Master Settlement Agreement (MSA) covered 39 states that filed lawsuits and seven states that had yet to sue. The settlement does not apply to the four states that previously settled their lawsuits.

Industry Payments – The funding provisions of the Settlement include:

- An annual industry payment in perpetuity to the 46 settling states plus \$12.7 billion in “up-front” payments. Up-front payments were distributed in December 1998 and are scheduled to continue through January 2003. Annual payments will total \$195.9 billion through the year 2025 and will be adjusted annually for inflation and sales volume.
- \$8.6 billion for a strategic contribution fund that will be paid to states over a 10-year period, beginning April 2008, and will be allocated based on efforts expended to resolve the state lawsuits against tobacco companies. Iowa's share will be approximately \$234.0 million.

- \$50.0 million for an enforcement fund available to states to prosecute settlement violations. Payments will be made to a national escrow agent and made available to states as needed for prosecution.
- \$1.45 billion for a sustained advertising program to counter youth tobacco use and educate consumers about tobacco-related diseases. Payments will be made to a foundation that will use the funds to administer a national campaign.

Iowa will receive approximately \$1.98 billion (0.87%) of the total funds allocated for distribution to the states. From FY 1998 through FY 2001, Iowa has received \$144.4 million. Unadjusted payments for future fiscal years are as follows:

- FY 2002 – FY 2004: \$155.1 million.
- FY 2005 – FY 2007: \$178.9 million.
- FY 2008 – FY 2010: \$189.4 million.
- FY 2011 – FY 2013: \$197.0 million.
- FY 2014 – FY 2016: \$204.6 million.
- FY 2017 – FY 2019: \$228.2 million.
- FY 2020 – FY 2022: \$237.0 million.
- FY 2023 – FY 2025: \$247.0 million.

The estimated receipts include strategic payments, receipts due from the Master Settlement Agreement, and net litigation payments. The estimate assumes an average annual decline in cigarette sales of 2.67% through 2004. The average annual decline for succeeding years is assumed to be 1.62%. Estimated payment amounts, however, may change significantly once volume and inflation adjustments are computed. An inflation adjustment equal to the greater of the Consumer Price Index, or 3.00%, is applied to each year's payment amount. A volume adjustment is also applied to each year's payment amount to reduce payment, if cigarette sales decrease compared to the 1997 volume.

2000 Legislative Session – The General Assembly appropriated the following amounts for FY 2001:

- Human Services Healthy and Well Kids in Iowa (HAWK-I): \$235,000
- Human Services Provider Rates: \$26.3 million.
- Public Health Tobacco Cessation Programs: \$9.3 million.
- Public Health Healthy Iowans 2010 Programs: \$2.8 million.
- Public Health Substance Abuse Treatment: \$11.9 million.
- Community-Based Corrections (CBC) for drug courts and day programming: \$610,000.
- Savings Account for Healthy Iowans: \$3.8 million.
- Transfer to the General Fund: \$64.6 million.

In addition, the General Assembly passed HF 2579, creating the Tobacco Settlement Authority with the governing board comprised of the Treasurer of State, the State Auditor, and the Director of the Department of Management. The Act began the process necessary for the State to sell its future tobacco settlement payments due from the Master Settlement Agreement.

2000 Interim – The Tobacco Settlement Authority hired Public Financial Management (PFM) as its financial advisor. The Authority retained the partnership of Hawkins, Delafield & Wood in conjunction with Ahlers, Cooney, Dorweiler, Haynie, Smith, and Allbee, P.C. as special counsel. The Hawkins Law Firm has been involved in previous tobacco securitization issues in other

jurisdictions and will serve as senior counsel. The Authority hired the Dorsey and Whitney Law Firm for its expertise regarding the State's investment policies and legislation. The financial advisor and legal counsel will only be compensated if a tobacco securitization issue is sold in the financial markets.

CURRENT SITUATION

2001 Legislative Session – The General Assembly passed the following Acts related to tobacco securitization:

- SF 532 (Tobacco Securitization Act), SF 533 (Tobacco Settlement Trust Fund Act)
- SF 537 (Healthy Iowans Tobacco Trust Act)
- HF 413 (Teacher Compensation Reform and Student Achievement Act)
- HF 755 (Standing Appropriations Act)
- HF 742 (Infrastructure Appropriations Act).

Attachment 1 shows the flow of tobacco funds as a result of the enactment of the legislation during the 2001 Legislative Session.

Senate File 532

Senate File 532 authorizes securitization of the tobacco settlement payments. The Act authorizes the sale of approximately \$600.0 million of tax-exempt and \$50.0 million in taxable securities for 30 years. Bond proceeds are estimated to be \$576.8 million that will be placed in the Tobacco Settlement Trust Fund. In addition, interest on the proceeds will remain in the Trust.

The Act creates the Tax-Exempt Bond Proceeds Restricted Capital Fund Account. Funds within the Restricted Capital Fund Account will be used for litigation payments, qualified capital projects, and certain debt service. **Attachment 2** illustrates the FY 2002 estimated receipts and appropriations for the Restricted Capital Fund Account.

The Act also creates the Endowment for Iowa's Health Account to hold net proceeds of any taxable or tax-exempt bonds issued to provide funds for health-related programs, any portion of the State's tobacco settlement payments that are not sold to the Tobacco Settlement Authority, and any other moneys appropriated to the Account. Senate File 532 transfers \$55.0 million from the Endowment to the Healthy Iowans Tobacco Trust, to be used for health-related programs. **Attachment 3** shows the FY 2002 estimated receipts and appropriations for the Endowment for Iowa's Health Account and the Healthy Iowans Tobacco Trust Account.

Senate File 533

Senate File 533 (Tobacco Settlement Trust Fund Appropriations Act) redirects the State wagering tax allocation to the Endowment for Iowa's Health Account and makes General Fund appropriations to the Endowment over a six-year period. The Act makes the following allocations from the State wagering taxes:

- FY 2002: \$80.0 million
- FY 2003: \$75.0 million
- FY 2004: \$70.0 million
- FY 2005: \$70.0 million
- FY 2006: \$70.0 million
- FY 2007: \$70.0 million

Under current law, these revenues are deposited in the Rebuild Iowa Infrastructure Fund. The Act also makes the following General Fund appropriations to the Endowment:

- FY 2002: \$7.2 million
- FY 2003: \$27.1 million
- FY 2004: \$28.3 million
- FY 2005: \$29.8 million
- FY 2006: \$29.6 million
- FY 2007: \$17.8 million

Senate File 537

Senate File 537 appropriates a total of \$60.3 million to the Departments of Human Services, Public Health, Corrections, and Education for health-related initiatives. Of the \$60.3 million, \$57.2 million is appropriated from the Healthy Iowans Tobacco Trust and \$3.1 million from the Savings Account for Healthy Iowans. The Act transfers the FY 2001 ending balance of the Savings Account for Healthy Iowans to the Healthy Iowans Tobacco Trust and also directs the reversions from the FY 2001 appropriations to the Fund. The FY 2002 beginning balance in the Healthy Iowans Tobacco Trust Fund is \$10.3 million. **Attachment 3** lists the revenues and individual appropriations of the Healthy Iowans Tobacco Trust Fund.

House File 413

House File 413 appropriates \$40.0 million from the Endowment for Iowa's Health Account to the Student Achievement and Teacher Quality Program. The Department of Education estimates the first payments to school districts could be made as early as October 15, 2001. The amount of the monthly payments to implement the teacher salary increases is estimated to be \$3.5 million over nine months. This amounts to a total of \$31.5 million. The remaining \$8.5 million is to be used for a variety of other education programs. The monthly payments for these programs cannot be determined at this time. For purposes of this report, it is assumed the \$8.5 million will be paid out in six equal installments beginning in December 2001.

House File 755

House File 755 appropriates \$17.9 million from the bond proceeds of the Tobacco Settlement Trust Fund. The appropriations include \$10.6 million for attorney litigation payments and \$7.2 million for FY 2002 debt service payments for the Iowa Communications Network (ICN), Regents Academic Revenue Bonds, and Prison Debt Service. In prior years, these payments were made from the General Fund and the Prison Infrastructure Fund.

House File 742

House File 742 appropriates \$107.0 million from the tax-exempt bond proceeds of the Tobacco Settlement Trust Fund for numerous infrastructure projects. In the event that the State is not successful in securitizing the tobacco proceeds, \$84.4 million of the total appropriations will be funded from the Rebuild Iowa Infrastructure Fund (RIIF). The three projects comprising the remaining \$22.6 million would not be funded. These projects include the State Laboratory Facility (\$16.7 million), the ICN ATM Conversion (\$3.5 million), and the Iowa Public Television (IPTV) High Definition Conversion (\$2.4 million).

Section 48.2 of HF 742 allows payments for costs incurred on infrastructure projects to be paid from the RIIF until the bond proceeds are received. Once the bond proceeds are received, the RIIF will be reimbursed for payments made against the infrastructure projects. This provision does not apply to the State Laboratory Facility, the ICN ATM Conversion, or the IPTV High Definition Conversion.

Attachment 2 lists the revenues and individual appropriations included within the Restricted Account of the Tobacco Settlement Trust Fund.

2001 Interim – The Tobacco Settlement Authority hired the investment banking firms of Solomon Smith Barney, senior manager, and Bear Stearns, co-senior manager. Other firms serving as co-managers include Merrill Lynch, First Albany, Morgan Stanley, Lehman Brothers, US Bancorp, Piper Jaffrey, A.G. Edwards, and Goldman Sachs. The fee for these underwriting services is contingent upon the successful securitization of tobacco payments. If securitization occurs, the financial team will be paid from bond proceeds. The financial team estimates that it will successfully close the securitization issue by late October 2001. The estimated cost for securitizing tobacco receipts is \$7.86 million.

BUDGET IMPACT

Projected Cash Flow of the Endowment for Healthy Iowans

The timing of the receipt of the bond proceeds and State wagering taxes is critical to the cash flow of the programs funded through the tobacco securitization. The appropriations contained in SF 532, SF 533, HF 413, HF 742, and HF 755 are effective when the net proceeds of the tobacco securitization are deposited into the respective accounts of the Tobacco Settlement Trust Fund. House File 742 permits the RIIF to cash flow the capital projects that are contingently funded from the net proceeds of tobacco securitization.

Attachment 4 shows the estimated cash flow of the Endowment for FY 2002. The bond proceeds are expected to be received in mid to late October 2001. The first installment of State wagering tax receipts will not likely be deposited into the Endowment until December 2001. Until the bond proceeds are received, the amount that can be withdrawn from the Endowment will be limited.

For purposes of developing a cash flow model for FY 2002, assumptions were made regarding the allocation of funds to the Healthy Iowans Tobacco Trust Fund and the Teacher Compensation Program. The assumptions are listed below:

- The FY 2002 wagering tax receipts will be remitted to the State in the same proportion as FY 2001. The first payment to the Endowment is expected to be received in December 2001.
- The General Fund appropriation will be allocated to the Endowment in June 2002.
- The bond proceeds will be deposited into the Endowment in the last half of October 2001.
- The residual tobacco payments will be deposited into the Endowment in April. The residual payment is the amount of the tobacco payment (received from the tobacco industry) that is in excess of the debt service paid to the bondholders.
- The interest is based on an annual rate of 4.20%.
- The \$55.0 million allocated to the Healthy Iowans Tobacco Trust Fund will begin to be transferred in October 2001. The allocations are based on cash flow projections of the programs funded through the Fund. From July to September of 2001, the programs funded through Healthy Iowans Tobacco Trust Fund will operate from the \$10.3 million balance transferred from the Savings Account for Healthy Iowans.
- The \$40.0 million teacher compensation appropriation will be allocated as follows:

- \$31.5 million will be allocated in nine equal installments of \$3.5 million beginning in November 2001.
- \$8.5 million will be allocated in six installments of approximately \$1.4 million beginning in February 2002.

The estimated FY 2002 ending balance in the Endowment is projected to be \$41.3 million. A portion of this balance will be needed in FY 2003 for cash flow purposes due to the timing of deposits from the wagering taxes and residual tobacco payments. In addition, assuming the goal of the General Assembly is to maximize the 30-year earnings potential of the Endowment (i.e., establish a \$1.0 billion Endowment by FY 2030), it is critical to not significantly spend down the FY 2002 ending balance.

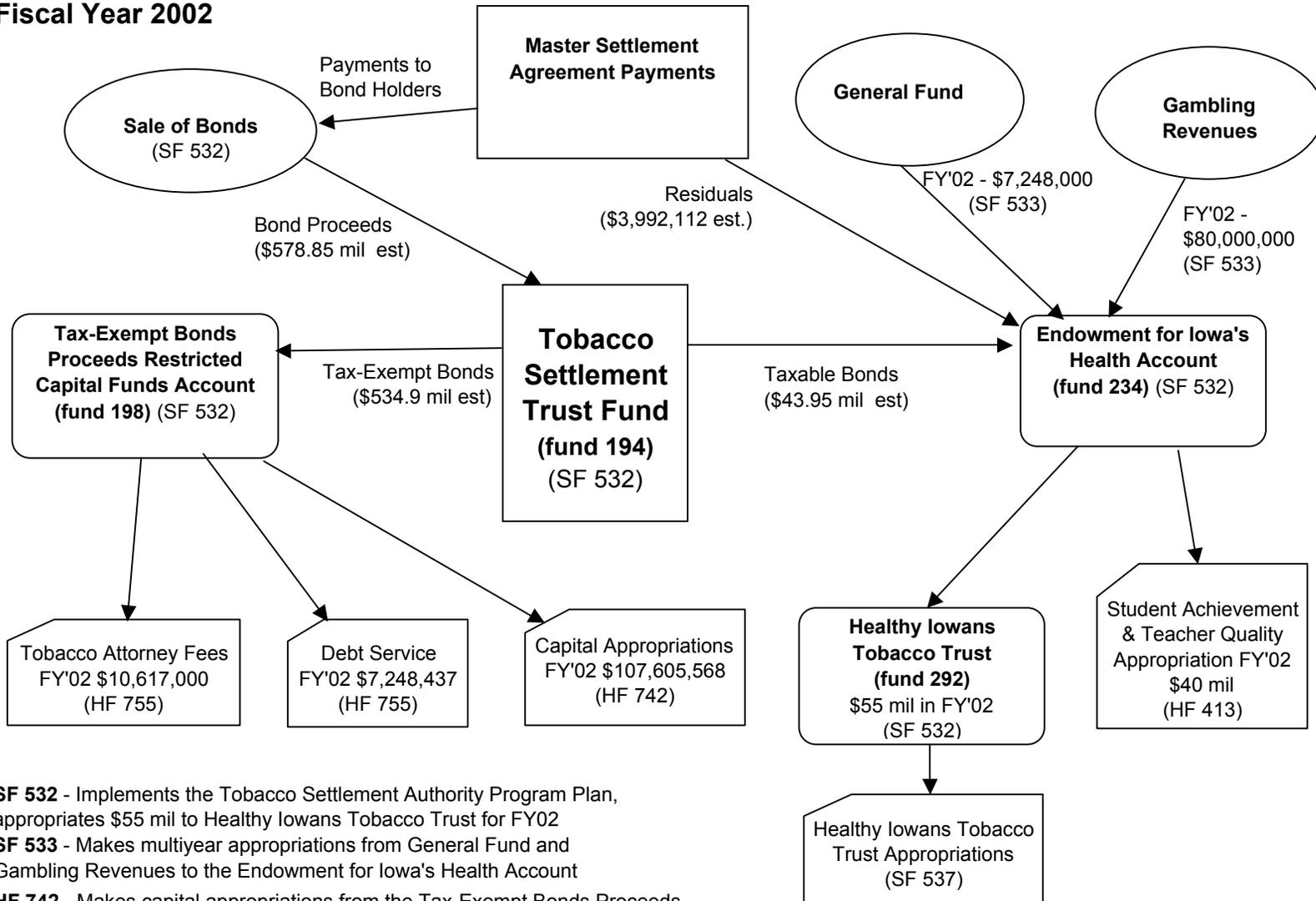
Repayment of Teacher Salary Compensation Appropriation

Senate File 531 (Administration and Regulation Appropriations Act) provides for repayment of the \$40.0 million appropriation to the Endowment. The repayment is to come from the excess revenues in the Economic Emergency Fund at the end of FY 2001 and FY 2002 after the first \$163.8 million is transferred to the General Fund. Using current revenue estimates there will not be any excess funds available to reimburse the Endowment for the teacher compensation appropriation in FY 2002. If the \$40.0 million is not reimbursed to the Endowment, the 30-year earnings projection will be significantly reduced, perhaps by as much as \$300.0 million.

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Iowa's Tobacco Settlement
<http://staffweb.legis.state.ia.us/lfb/IRVIEW/irview.htm>
LFB: IRBAL001.Doc/10-17-01/9:20 am/fc

**Tobacco Securitization
Flow of Funds
Fiscal Year 2002**



SF 532 - Implements the Tobacco Settlement Authority Program Plan, appropriates \$55 mil to Healthy Iowans Tobacco Trust for FY02

SF 533 - Makes multiyear appropriations from General Fund and Gambling Revenues to the Endowment for Iowa's Health Account

HF 742 - Makes capital appropriations from the Tax-Exempt Bonds Proceeds Restricted Capital Funds Account

HF 755 - Makes tobacco attorney fee and debt service appropriations from the Tax-Exempt Proceeds Restricted Capital Funds Account

SF 537 - Makes appropriations from the Healthy Iowans Tobacco Trust

HF 413 - Makes the \$40 mil appropriation from the Endowment for Iowa's Health Account for teachers salaries

SF 531 - Provides for the repayment of the \$40 mil appropriation in HF 413

Tobacco Settlement Trust Fund
Restricted Capital Funds Account

	Estimated FY 2002	Governor's Item Vetoes FY 2002	Estimated Net FY 2002	Bill Number
Resources				
Tobacco Settlement Bond Proceeds	\$ 534,900,000		\$ 534,900,000	
Interest	24,494,488		24,494,488	
Total Available Resources	<u>\$ 559,394,488</u>		<u>\$ 559,394,488</u>	
Appropriations				
Attorney Litigation				
Payments	<u>\$ 10,617,000</u>	<u>\$ 0</u>	<u>\$ 10,617,000</u>	HF 755
Debt Service				
ICN - Debt Service	\$ 1,465,835		\$ 1,465,835	HF 755
Tuition Replacement	600,330		600,330	HF 755
Prison Debt Service	5,182,272		5,182,272	HF 755
Total Debt Service	<u>\$ 7,248,437</u>	<u>\$ 0</u>	<u>\$ 7,248,437</u>	
Capital Appropriations				
ICN - ATM Conversion	\$ 3,500,000	\$ 0	\$ 3,500,000	HF 742
IPTV - HDTV Conversion	2,400,000		2,400,000	HF 742
DPD - Armory Maintenance	700,000		700,000	HF 742
DPD - Estherville Readiness Center	400,000		400,000	HF 742
DGS - Major Maintenance	11,500,000		11,500,000	HF 742
DGS - Capitol Interior Renovation	1,700,000		1,700,000	HF 742
DGS - Des Moines Metro. Medical Center Option	500,000		500,000	HF 742
DGS - Property Appraisal	250,000		250,000	HF 742
DGS - Property Acquisition & Site Development	200,000		200,000	HF 742
DGS - Court Avenue Bridge	400,000	-400,000	0	HF 742
DGS - Laboratory Facility	16,670,000		16,670,000	HF 742
Judicial Branch Facility Design/Construction	10,300,000		10,300,000	HF 742
DNR - Restore the Outdoors Program	2,500,000		2,500,000	HF 742
DNR - Destination State Park	1,000,000		1,000,000	HF 742
DOC - Fort Madison Prison Expansion	6,400,000		6,400,000	HF 742
DOC - Ft. Madison Electrical System Upgrade	333,168		333,168	HF 742
DOC - Oakdale Water Access	100,000		100,000	HF 742
DOC - Mitchellville Waste Water Facility	364,400		364,400	HF 742
DED - Accelerated Career Education (ACE) Program	2,500,000		2,500,000	HF 742
DED - Community Attraction/Tourism	12,500,000		12,500,000	HF 742
DPS - Patrol Post Construction	250,000	-250,000	0	HF 742
DOT - Recreational Trails	1,000,000		1,000,000	HF 742
DOT - Commercial Aviation Infrastructure	1,000,000		1,000,000	HF 742
DOT - General Aviation Airports	500,000		500,000	HF 742
Treasurer of State - County Fairs	1,060,000		1,060,000	HF 742
State Fair Authority	500,000		500,000	HF 742
Regents - Gilman Hall - ISU	2,500,000		2,500,000	HF 742
Regents - Biology Building Renovation - SUI	7,300,000		7,300,000	HF 742
Regents - McCollum - UNI	5,800,000		5,800,000	HF 742
Regents - Art Building - SUI	4,453,000		4,453,000	HF 742
Regents - Steam Distribution - UNI	3,990,000		3,990,000	HF 742
Regents - Business Building - ISU	4,200,000		4,200,000	HF 742
Special Schools	835,000		835,000	HF 742
Total	<u>\$ 107,605,568</u>	<u>\$ -650,000</u>	<u>\$ 106,955,568</u>	
Total Appropriations	<u>\$ 125,471,005</u>	<u>\$ -650,000</u>	<u>\$ 124,821,005</u>	
Ending Balance	<u>\$ 433,923,483</u>		<u>\$ 434,573,483</u>	

Tobacco Settlement Trust Fund Unrestricted Funds

	Endowment for Iowa's Health Account FY 2002	Healthy Iowans Tobacco Trust FY 2002
Resources		
Balance	\$ 0	\$ 10,330,000
Transfer from the Endowment for Iowa's Health Account		55,000,000
Bond Proceeds	43,950,000	
General Fund Transfers	7,248,000	
Wagering Tax Allocation Transfer	80,000,000	
Tobacco Settlement Residuals	3,992,118	
Interest Earned	1,117,159	84,863
Total Available Resources	\$ 136,307,277	\$ 65,414,863
Appropriations		
Healthy Iowans Tobacco Trust		
Transfer to Healthy Iowans Tobacco Trust Account	\$ 55,000,000	\$ 0
Dept. of Public Health		
Tobacco Use Prevention/Control	\$ 0	\$ 9,345,394
Tobacco Use Prevention/Control (FY 2001)		500,000
Substance Abuse		11,825,000
Healthy Iowans 2010		2,550,000
Smoking Cessation Products		75,000
Substance Abuse Treatment Facility		2,000,000
Total Dept. of Public Health	\$ 0	\$ 26,295,394
Dept. of Human Services		
Physician and other medical providers	\$ 0	\$ 8,095,718
Dental Provider Increase		3,814,973
Hospital Provider Increase		3,035,278
Home Health Care Provider Increase		2,108,279
Critical Access Hospitals		250,000
Home Health and Habilitative Day Care Expansion		1,975,496
Respite Care Expansion		1,137,309
CHIP Expansion to 200% of Federal Poverty Level		200,000
Breast/Cervical Cancer Treatment		250,000
Supplement Medicaid		7,500,000
Res. Treatment Support Services Provider Increase		3,243,026
Adoption, Ind. Living, Shelter Care, and Home Studies Provider		468,967
Provider Rate/Methodology Changes		545,630
Purchase of Service Provider Increase		146,750
Total Dept. of Human Services	\$ 0	\$ 32,771,426
Dept. of Corrections		
CBC District II	\$ 0	\$ 127,217
CBC District III		35,359
CBC District IV		191,731
CBC District V		255,692
Total Dept. of Corrections	\$ 0	\$ 609,999
Dept. of Education		
Teacher Compensation	\$ 40,000,000	\$ 0
Iowa Empowerment Fund		1,153,250
Total Dept. of Education	\$ 40,000,000	\$ 1,153,250
Total Appropriations	\$ 95,000,000	\$ 60,830,069
Ending Balance	\$ 41,307,277	\$ 4,584,794

**Endowment for Iowa's Health Account
Projected Cash Flow
FY 2002**

	July	August	September	October	November	December	January
Beginning Balance	\$ 0	\$ 0	\$ 0	\$ 0	\$ 42,950,000	\$ 37,265,714	\$ 32,787,026
Wagering Tax General Fund						9,233,349	16,274,501
Bond Proceeds				43,950,000			
Residuals							
Interest					115,714	87,963	40,982
Total Revenues	0	0	0	43,950,000	43,065,714	46,587,026	49,102,509
Healthy Iowans Approp. Student Achievement				1,000,000	2,300,000	10,300,000	2,300,000
					3,500,000	3,500,000	3,500,000
Total Expenditures	0	0	0	1,000,000	5,800,000	13,800,000	5,800,000
Ending Balance	\$ 0	\$ 0	\$ 0	\$ 42,950,000	\$ 37,265,714	\$ 32,787,026	\$ 43,302,509

	February	March	April	May	June	FY 02 Closeout	Total
Beginning Balance	\$ 43,302,509	\$ 51,798,007	\$ 57,378,765	\$ 70,773,803	\$ 64,583,951	\$ 56,098,862	\$ 0
Wagering Tax General Fund	15,609,684	21,363,556	16,694,984	823,926			80,000,000
Bond Proceeds					7,248,000		7,248,000
Residuals			3,992,118				43,950,000
Interest	102,481	133,868	124,603	202,889	183,577	125,082	3,992,118
Total Revenues	59,014,674	73,295,431	78,190,470	71,800,618	72,015,528	56,223,944	136,307,277
Healthy Iowans Approp. Student Achievement	2,300,000	11,000,000	2,500,000	2,300,000	11,000,000	10,000,000	55,000,000
	4,916,667	4,916,667	4,916,667	4,916,667	4,916,667	4,916,667	40,000,000
Total Expenditures	7,216,667	15,916,667	7,416,667	7,216,667	15,916,667	14,916,667	95,000,000
Ending Balance	\$ 51,798,007	\$ 57,378,765	\$ 70,773,803	\$ 64,583,951	\$ 56,098,862	\$ 41,307,277	\$ 41,307,277

Assumptions:

- 1) FY 2002 wagering tax receipts will be remitted to the State in the same proportion as FY 2001.
- 2) The General Fund appropriation will be allocated to the Endowment in June of 2002.
- 3) The bond proceeds will be deposited into the Endowment in October.
- 4) The residual tobacco payments will be deposited into the Endowment in April.
- 5) Interest is based on an annual rate of 4.2%.
- 6) The \$55.0 million allocated to the Healthy Iowans Tobacco Trust Fund will begin to be transferred in October.
- 7) The \$40.0 million teacher compensation appropriation will begin to be allocated in November.